Investors and Private Placement

by Sophia

WHAT'S COVERED

What are some other ways that a company can obtain money for long term needs? We've discussed bonds, equity, stocks, and short term financing, but what are some other options if none of these are available to a company? This tutorial will cover investors and private placement, examining alternate forms of financing. Our discussion breaks down as follows:

1. Angel Investors

Alternative financing can take the form of an **angel investor**, which is an individual who provides funding from their personal finances to a business, typically receiving ownership equity or a type of bond in exchange.

Angel investors can also be a means of raising money for a business that appears to have a very high earnings potential, but quite a bit of risk associated with it, meaning some of the more traditional means of financing wouldn't necessarily be available to them.

IN CONTEXT
A good example of an angel investor is Jeff Bezos, who owns a company called Zappos. He uses his own money to invest in an area of Las Vegas where he set up his company. He does this in order to reinvigorate the community around where his business is placed.

For the individuals and companies who are trying to build a business in this area, Mr. Bezos is known as an angel investor, because he's investing his own money into something that is not necessarily proven and also a high-risk area, with the expectation that there is a fairly high potential to get that money back—and a little bit more.

Generally, angel investors will expect to have a share of ownership in exchange for the funds. Those on the receiving end of the funds are not just going to pay the money back; the angel investor will now be part owner in the business that they invest in.

Angel investors typically:

- Take riskier investments
- Provide initial funding, right out of the gate as a business is starting up and it needs money right now.
- Invest in passion projects

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- Are individuals--one person investing his or her own money.

TERM TO KNOW

Angel Investors
An individual who provides funding from their personal finances to a business; typically receiving ownership equity or a type of bond in exchange.

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2. Venture Capitalist

A venture capitalist has or uses venture capital. **Venture capital** is funding during the beginning stages of a new company or venture to get the business started in exchange for owner's equity. This is provided to start-up companies that appear to have a fairly high potential, by a group of investors. Again, these companies are too risky for banks to loan them money. The bank doesn't want to take on that risk, which is how venture capital can work.

A group of investors will look at potential moneymakers that have a lot of potential but a lot of risk, and they will invest their money to get the business started and off the ground.

Investors and firms that offer venture capital are considered to be limited partners. They don't necessarily have a say in ownership of the business, but they do have owner equity in the business.

It's important to note that venture capital funds are typically going to be for no longer than 10 years. Management fees and interest are charged for loaning the funds to the start-up business.

Venture capitalists typically:

- Asses risk more thoroughly
- Provide growth funding for a business to help it get off the ground and moving. Because if the business doesn't get moving, then there's no chance for the venture capitalist to make that money back and make use of that owner equity in the business.
- Function as a group, not individuals like angel investors.

TERM TO KNOW

Venture Capital
Funding during the beginning stages of a new company or venture to get the business started or to fund the expansion activities of a small company; in exchange for owner's equity.

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3. Private Placement

Private placement is the selling of any tradable asset by a firm to a closed set of investors. These assets are not offered to the public; they could include a non-public offering of stock, for instance, to a group of closely held investors in a particular company.

Private placement firms are not registered with the SEC. Because it's not a publicly traded stock, it's not governed by the Securities and Exchange Commission. Now, it can also be common stock, bonds, or

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promissory notes that are issued. Typically, smaller businesses are going to be the best candidates for private placement.

In addition, banks or funds are going to purchase these offerings of stocks or bonds at a lower cost than stocks, and the funding can be made available fairly quickly, because the parties involved don't have to go through all the regulation of putting an IPO out and having it regulated by the SEC.

TERM TO KNOW

Private Placement
The selling of any tradable asset by a firm to a closed set of investors.

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4. Risk Return Relationship

Risk return relationship is the concept that the higher a risk is, the higher the potential return is. Safer investments will typically have lower returns than risky investments. Risky investments will typically tend to have higher returns.

Now, if you invest in something with a very low risk, then you have what is called a conservative investment. Conservative investments are generally considered very safe, but they don't return very much money.

EXAMPLE A certificate of deposit or a corporate bond, especially one that is backed by mortgage assets, or even a government bond are all considered to be very safe. They are very safe types of investment, but as a result, the return on them will be very low.

Aggressive investments, on the other hand, are investments that are typically very risky, but the potential for return is also very high. Angel investing, discussed earlier, is an example of this type of investment, because it involves investing in companies that are unknown, just starting off and with absolutely no history. There is a lot of risk involved. However, if the company does well then there's a potential for a very high return on investment.

Other types of aggressive investments include:

- Low quality stocks or penny stocks
- Junk bonds, or bonds that don't have a very good financial rating
- Unproven stock that is just starting off and issuing its IPO

The idea here is that you're getting in very low and very near the beginning of the business's operation. So, any time that business grows, you're benefiting from the entire growth of the whole business. This is what makes those businesses attractive to aggressive investors—the potential of that high return. Keep in mind, though, that there is also a high risk that you'll lose that money and you won't have anything to show for it.

TERM TO KNOW

Risk Return Relationship
The concept that the higher a risk is, the higher potential return is as well.

SUMMARY

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Today we learned about alternative financing, focusing on **angel investors**. We also learned about **venture capitalists** and **private placement**. Lastly, we learned about the concept of the **risk return relationship**: the higher the risk, the higher the potential return on that investment.

Good luck!

Source: adapted from sophia instructor james howard

TERMS TO KNOW

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Private Placement
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Risk Return Relationship
The concept that the higher a risk is, the higher potential return is as well.

Venture Capital
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